Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended;	)	**CC Docket No. 96-149**
	)	
and	)	
	)	DOCKET FILE COPY ORIGINAL
Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area	)	
	)	

Reply Comments of Citizens for a Sound Economy Foundation

Summary of Position

Citizens for a Sound Economy Foundation (CSE Foundation) hereby offers these reply comments for the above-referenced proceeding. Founded in 1984, CSE Foundation is a nonprofit research and educational organization with 250,000 members and supporters in every state in the country. We have been active in a broad range of telecommunications policy concerns since 1988, addressing such issues as the regulatory status of local and interexchange carriers, universal service, and the use of the electromagnetic spectrum.

As required by the Telecommunications Act of 1996, the instant proceeding involves a number of issues related to the regulation of local exchange carriers in their provision of in-region interLATA services. Among other issues, the Commission considers in this proceeding whether to regulate Bell Operating Carriers (BOCs) as dominant carriers in the provision of in-region, interstate interLATA services in the domestic market, and whether such a classification is equally applicable for the BOCs international services.

CSE Foundation believes that some of the Commission's proposed plans may be overly regulatory and burdensome, while providing no countervailing benefits. Specifically, prohibitions on BOCs joint marketing of long-distance and local service would likely prevent many significant economies of scope from being achieved, the savings from which could be passed on to the consumer. We recognize the Commission's concern about potential cross-subsidies from regulated to unregulated markets in order to acquire market share or obtain monopoly profits. At the same time, we believe that while the potential for an abuse of market power exists due to the control of a local exchange "bottleneck" in some markets, the

Telecommunications Act of 1996 establishes sufficient guidelines to prevent such abuse in joint marketing as well as other arrangements.

With regard to the Bell Operating Companies status in providing in-region domestic and international service, CSE Foundation maintains that non-dominant status would be both appropriate to the market as it now exists and in the best interests of consumers. As with other issues in the regulation of in-region BOC services, the relevant questions come down to whether these carriers have the ability and incentive to cross-subsidize. Such cross-subsidization is ineffective -- if not impossible -- in the face of competition. Given the 1996 Act's make clear requirement that barriers to competition be eliminated prior to BOC entry into these new markets, status as non-dominant providers should be awarded to these new providers in both domestic and international markets.

While CSE Foundation does not offer reply comments to every question addressed in the instant proceeding, we urge the Commission to adopt a conservative approach to further regulation. The 1996 Act clearly outlines a regulatory checklist that local exchange carriers must meet prior to their receiving permission to offer many of the services in question. An even more regulatory structure would not bring additional protection to consumers; indeed, even more rigid requirements than those mandated in the 1996 Act would only serve to limit consumers' options in the marketplace.

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I. Introduction

The Telecommunications Act of 1996 laid the groundwork for significant changes in what is rapidly becoming one of the most important industries for the U.S. economy. As stated in the accompanying conference report, this legislation is designed "to provide for a pro-competitive, deregulatory national policy framework" that will spur private investment and promote competition in both new and existing telecommunications markets. As a result of this deregulatory framework, telecommunications providers of all varieties will be free to pursue opportunities in different markets. Local exchange carriers, interexchange carriers, cable companies, and many others can expect to find increasingly open markets, as barriers

[1] Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996 Act), Preamble (Joint Explanatory Statement).

to entry and other regulatory impediments are removed.

However, this emergence of a truly deregulated telecommunications market and the removal of significant barriers to entry will not take place in a vacuum. Rather, the Commission must promulgate rules to make this transition happen. The instant proceeding considers rules related to non-accounting separate affiliate and nondiscrimination safeguards for Bell Operating Companies (BOCs), as well as these carriers' classification as dominant or non-dominant in the provision of in-region interLATA long-distance services. The separate affiliate and nondiscrimination considerations are issues raised by the 1996 Act, while the regulatory treatment of local carriers in the long-distance market adds a new perspective on a debate that has evolved over many years. Both of these issues merit a response that reflects the deregulatory nature of the Act itself.

II. Non-Accounting Separate Affiliate and Nondiscrimination Safeguards

The proceeding and subsequent comments indicate both the level of detail involved in the implementation of Sections 271 and 272 requirements and the level of disagreement among the various industry participants. In general, the Bell Operating Carriers advocate a limited application of the Sections 271-272 rules, arguing that Congress did not grant the Commission authority to expand beyond these requirements and that such regulatory

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[2] "In the Matter of Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended; and Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area," Notice of Proposed Rulemaking, ("NPRM"), Federal Communications Commission, CC Docket No. 96-149 (July 18, 1996), Para. 1-4.

[3] Telecommunications Act of 1996, Sec. 271-2.

[4] See "In the Matter of Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier," Federal Communications Commission Order, FCC 95-427 (October 23, 1995).

intervention would be unnecessary. Interexchange carriers, in contrast, argue that additional rules such as those considered in the instant proceeding are needed in addition to the mandates established in the legislation; otherwise, unfair and perhaps anticompetitive behavior by the local exchange providers will result.

CSE Foundation does not attempt to reply to all of the comments addressing the implementation of Section 271-272, noting that discussion of these issues by the Commission took up the first 53 pages of the proceeding (over 100 paragraphs), with considerably more debate added by the various commenters. We do, however, strongly believe that at least some of the Commission's considerations mentioned in the proceeding have the potential to lead to overly regulatory results.

Perhaps the most obvious potential for unnecessary and overly burdensome regulation comes in the proceeding's discussion of additions to the marketing provisions of Sections 271 and 272. The 1996 Act clearly indicates that Bell Operating Companies must use separate affiliates for specific manufacturing operations as well as to provide in-region interLATA telecommunications and information services. The legislation also dictates the extent to which these affiliates must maintain their independence, mandating the use of separate books and records; separate officers, directors and employees; prohibitions on any credit that has recourse to the parent BOC; and an "arm's length" standard for all transactions between the

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[5] See, for example, NPRM, comments of Bell Atlantic Corporation, Bell South Corporation, and United States Telephone Association.

[6] See, for example, NPRM, comments of AT&T Corporation, MCI Corporation, and Sprint Corporation.

[7] NPRM, Para. 90-93.

[8] Telecommunications Act of 1996, Sec. 272(a)(2).

affiliate and the parent BOC.

Given the legislation's straightforward presentation of the above rules governing BOC operation in these markets, it is disturbing that the Commission would consider adding even more requirements. Specifically, this proceeding requests "comment on whether, instead of allowing BOC personnel to market their affiliate's services at arm's length, it is necessary to require a BOC and its affiliate to jointly contract to an outside marketing entity for joint marketing of interLATA and local exchange service in order to comply with the provisions of section 272(b)(3)," which pertains to the mandate for separate officers, directors, and employees between an affiliate and a BOC. The problem posed here is one of allocation of employees for joint marketing purposes. While such a problem may require that joint efforts be clearly defined and conducted with arm's length transactions, it should not relegate such efforts to outside marketing entities.

A requirement that BOCs contract with an outside marketing entity would offer virtually no additional safeguards against cross-subsidization or other anticompetitive behavior on the part of the incumbent local carrier. The accounting techniques that will adequately maintain arm's length transactions in a joint marketing arrangement will likely differ little from those that an outside marketing entity must employ. The specific rules for such accounting are to be considered under a separate proceeding, and as such we will not consider the issue further in these reply comments. Nonetheless, under either arrangement -- marketing with an outside entity or not -- rules must be promulgated to ensure the

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[9] Ibid., Sec. 272(b).

[10] "Accounting Safeguards for Common Carriers Under the Telecommunications Act of 1996, Notice of Proposed Rulemaking, Federal Communications Commission, CC Docket No. 96-150 (July 18, 1996).

appropriate allocation of employees and other resources between a parent BOC and its affiliate.

While a requirement for BOCs to contract with outside marketing entities would offer no additional protection against anticompetitive behavior, it would have the unwanted effect of reducing the BOCs ability to better serve their customers. The Commission rightly notes that one-stop shopping and other benefits of joint marketing are to be expected as a result of the 1996 Act. Specifically, it may be less expensive for a provider to produce or market a bundle of goods and services than it would be to offer them individually. These savings may even be sufficient to overcome any particular diseconomies of scale (increasing costs) associated with producing various individual services.

As various scholar's have noted, antitrust and other authorities need not always thwart vertical integration in an industry based on concern over anticompetitive results. As Yale Brozen has observed:

> "Vertical mergers produce no anticompetitive effects. Preventing them in the name of preventing 'foreclosure' simply prevents the use of the cheapest method of obtaining the efficiencies of vertical integration. Hostility to such mergers may cause waste of the existing capital stock, redundant capacity, and the misallocation of current capital supplies..."

This observation has direct relevance to the joint marketing of telecommunications services.

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[11] NPRM, Para. 6.

[12] See, for example, Baumol, William J., John C. Panzar, and Robert Willig, Contestable Markets and the Theory of Industry Structure, Harcourt Brace Jovanovich (1982), pp. 71-9.

[13] Ibid, p. 74.

[14] See, for example, Brozen, Yale, Concentration, Mergers, and Public Policy, MacMillan Publishing (1982), and Williamson, Oliver, The Economic Institutions of Capitalism, The Free Press (1985).

[15] Ibid.

To the extent that arm's length accounting rules are stretched to include requirements for separate marketing entities, the greater will be the likelihood of redundancy and waste among BOCs and their affiliate service providers. The focus should instead be on how the cost to consumers drops under efficient production and the presence of competitors. Restrictions on joint marketing impart few if any of the benefits of increased competition while imposing potentially significant costs on consumers due to their having less-efficient providers.

III. Regulatory Treatment of LEC Provision of In-Region Interexchange Services

In addition to the consideration of Section 271 and 272 requirements, the instant proceeding addresses issues related to the regulatory treatment of Local Exchange Carriers in their provision of in-region, interexchange service. Specifically, the Commission considers whether to regulate such carriers as dominant in the provision of this service in the domestic market, and whether they should be classified as dominant in the international markets. CSE Foundation believes that the Bell Operating Carriers and independent LECs that meet the competitive checklist clearly specified in the 1996 Act should be classified as non-dominant in both domestic and long-distance markets, for the reasons described herein.

The relevant issue in making a determination of non-dominant status is the question of market power. As the Commission notes in the instant proceeding, and as stated in its Competitive Carrier Fourth Report and Order, market power refers to "the ability to raise

[16] NPRM, Para. 108.

[17] Ibid, Para. 114.

prices by restricting output," and accomplishing this without making it unprofitable. For the issue of BOCs and independent LECs' market power, the Commission posits the question as to what should be the appropriate product and geographic markets of analysis, and tentatively concludes that the focus should be on the BOC's own region.

Given that the Commission considered the entire nation as the relevant market in its evaluation of AT&T as a non-dominant provider, this focus on the local exchange market of the BOC affiliate or independent LEC may seem significant. To be sure, such an approach has been met with resistance by the affected providers. However, CSE Foundation feels that the question of the relevant product and geographic market should not be allowed to overshadow the more important question of the existence of market power in the first place, along with its potential for abuse.

The Commission is very clear in how it will test for the existence of market power: "With respect to each originating in-region location, the determination of whether a BOC affiliate or independent LEC possesses market power in that market will turn on...whether the BOC or independent LEC can leverage the market," which the Commission recognizes as a "power arising from its control of access facilities..." The tentative conclusion given is that, "at this stage, the BOCs' current monopoly control of bottleneck facilities" suggests the potential for an abuse of market power.

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[18] Ibid, Para. 114, and Competitive Carrier Fourth Report and Order, 95 FCC 2d at 558.

[19] Ibid, Para. 126.

[20] Ibid, Para. 125.

[21] Ibid, Para. 126.

This conclusion is significant, as it provides the Commission a basis from which it may examine a carrier's ability to profitably raise and sustain prices. As detailed above, dominant classification hinges on this ability to successfully raise prices, and conversely, non-dominant status reflects an inability to affect the market.

CSE Foundation believes that, while many BOC affiliates may indeed have the ability to exert significant market power, those that apply to offer interLATA services within their regions will not be among them. The reason for this conclusion is straightforward. The Telecommunications Act of 1996 provides that the Commission shall authorize such service only upon finding that the BOC in question has met an extensive competitive checklist, has conformed with nondiscrimination requirements to limit preferential treatment of its affiliate, and is "consistent with the public interest, convenience, and necessity."

These requirements are not insignificant. In fact, the competitive checklist is a very specific 14-point list that mandates, among other things, interconnection requirements, access to network elements, access to capital equipment such as the carrier's poles and conduits, unbundled local switching, and resale. Bell Operating Carriers that will be authorized to compete in their in-region interLATA market will have already provided these access and interconnection services to a facilities-based competitor.

These extensive requirements make it very unlikely that a Bell company will be able to exert market power with respect to long-distance service, because of the competition the

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[22] Telecommunications Act of 1996, Sec. 272(d)(3).

[23] Ibid, Sec. 271 (c)(2)(B).

[24] Ibid, Sec. 271(c)(1).

new rules are likely to bring about and because of the safeguards against cross-subsidy and discrimination they include. For this reason we believe that a BOC that successfully meets the requirements necessary to provide interLATA service, should also be regulated as a non-dominant carrier. This conclusion should apply for both domestic and international interLATA long-distance services.

CSE Foundation adds that, even if the Commission or outside parties feel that a Bell Operating Company might be certified to provide in-region long-distance service while still possessing market power (i.e., due to the lack of competition in part of the relevant market), the incentive to cross-subsidize can be further limited through an efficient price cap model. The Commission recognizes this as well, arguing that the elimination of a direct link between the costs carriers report and the prices they may charge effectively reduces their incentive to shift costs to the basic (regulated) sector.

However, the Commission also argues that current price cap rules for local exchange carriers do not perfectly de-link costs from the carriers' revenues, thus making it possible for some cost-shifting to take place. Pure price caps do not currently exist in the local exchange market, and thus the potential for cost-shifting is not trivial. However, we stress that efforts to adopt a regulatory approach based on pure price caps -- as opposed to modified approaches that incorporate benchmarks or other limitations -- will offer the most effective solution to any remaining cross-subsidy concerns. This is certainly a more efficient solution than the imposition of additional burdensome and costly regulations.

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[25] NPRM, Para. 136.

[26] Ibid.

Finally, CSE Foundation points out that the experience in classifying AT&T as a non-dominant carrier should prove useful in the present analysis. The Commission ultimately found that "AT&T neither possesses nor can exercise individual market power, within the interstate, domestic, interexchange market as a whole." Additionally, the Commission stated that application of dominant-carrier regulation could actually hinder competition in the long-distance market.

In the Commission's proceeding considering AT&T's status, the BOCs argued that a dominant carrier classification was necessary. In contrast, AT&T and others (including CSE Foundation) argued that non-dominant classification was appropriate. In the instant proceeding, many commenters see non-dominant classification of BOCs in a considerably different light. Predictably, AT&T considers such classification as an invitation to abuse, while the United States Telephone Association does not.

CSE Foundation reiterates the argument it made in 1995 in that proceeding: dominant carrier regulation does little to prevent such abuses, though it may have the negative effect of limiting new technologies or new services. For BOCs facing effective competition as determined by the 1996 Act's requirements, non-dominant status is appropriate in both the domestic and international markets.

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[27] "In the Matter of Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier," Federal Communications Commission Order, FCC 95-427, Para. 39.

[28] Ibid, Para. 52.

[29] Ibid, Para. 43 and 48.

[30] NPRM, comments of AT&T Corp. and comments of United States Telephone Association.

IV. The Importance of Competition

As we have argued before, CSE Foundation is a strong supporter of policies that increase the potential for competition in all telecommunications markets. This position is based not on the belief that more participants in a market equals a more competitive outcome (though this is frequently true), but on the belief that no one can know what new technology or which particular provider will best serve customers. Allowing more to compete makes it more likely that those providers and those technologies that best serve customers needs will actually be available to do so.

This is a dynamic -- not static -- definition of competition. We believe it is also the most appropriate view to take in the markets considered in this proceeding.

Consider, as an alternative perspective, the previous discussion of how different telecommunications providers view their competitors and how they would like to see them regulated. As technology, other market forces, and the Commission's implementation of the 1996 Act move this industry into an increasingly competitive market, such perspectives will become increasingly anachronistic.

CSE Foundation stresses that any transformation involving real competition will by definition not be smooth, systematic, planned or controlled. It may in fact be dramatic, causing a "creative destruction" that accompanies abandonment of old technologies and old

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[31] See, for example, "In the Matter of Policy and Rules Concerning the Interstate, Interexchange Marketplace and Implementation of Section 254 (g) of the Communications Act of 1934, as amended," Federal Communications Commission, CC Docket No. 96-61, Comments of Citizens for a Sound Economy Foundation (April 25, 1996); and "In the Matter of Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorization Therefor," Federal Communications Commission, CC Docket No. 79-252, Comments of Citizens for a Sound Economy Foundation (June 9, 1995).

service arrangements for newer approaches that better serve consumers. (Alternatively, the transformation may involve more incremental, but equally unpredictiable improvements.

The consequence of adopting this perspective on competition is a healthy respect for the limits of regulatory policy. Especially in an industry as dynamic as telecommunications, regulations designed to prevent an abuse of market power or other negative consequences may in fact create negative consequences of their own. These costs may include various technologies that cannot be developed except in large and vertically-integrated operations, management inefficiencies that accrue only when different functional divisions can share information and knowledge, or limits on the different markets that may be reached due to requirement for independent marketing and promotion.

Moreover, the most dramatic examples of opportunities foregone may not be visible. A carrier that cannot afford a promotional campaign unless it can spread the costs across all of its operations, an expansion program into a new market that is not competitive without a full range of service offerings, these would not likely be seen by anyone apart from a few senior managers. As a result, the cost of these benefits foregone remains unknown.

For the instant proceeding, none of these arguments are to say that the 1996 Act's requirements should therefore be ignored. Rather, CSE Foundation urges the Commission to avoid further restraining the BOCs or other carriers in their marketing arrangements, as well

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[32] See Schumpeter, Joseph, Capitalism, Socialism, and Democracy, Harper and Brothers (1942).

[33] See, Kirzner, Israel M., Competition and Entrepreneurship, University of Chicago Press (1973).

[34] See Pitsch, Peter, The Innovation Age: A New Perspective on the Telecom Revolution, Hudson Institute and The Progress and Freedom Foundation (1996). For a discussion of the limits of regulation in general and how this is tied to the knowledge limits of those charged with such regulation, see Hayek, Friedrich, Individualism and Economic Order, University of Chicago Press (1948), and Sowell, Thomas, Knowledge and Decisions, Basic Books (1980).

as in their provision of long-distance or other services.

V. Conclusion

While the issue of in-region long-distance service by the Bell Operating Carriers makes up only one part of the 1996 Act, the level of contention surrounding the debate obscures this fact. The new legislation, designed to promote a competitive and deregulated industry, lays out the ground rules as to how and under what conditions the BOCs will be authorized to provide this service. It is incumbent on the Commission to implement this process in a clear and orderly fashion, and with the overall goal of promoting the competition and deregulation the 1996 Act holds up as goals.

To this end, the Commission should avoid increasing the regulatory hurdle that BOCs must meet before they can add another layer of competition in an important market, as well as maintaining such a hurdle through the use of dominant carrier regulation. The decisions made by the Commission will affect much more than just current competitors in the long-distance market. The most significant impact will be felt by consumers, as new ways of organizing service and new opportunities are discovered. They should not be denied these benefits.

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